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In the
Supreme Court of the United States
October Term, 1995

Walter C. Kellogg, Trustee for
West Texas Marketing Corporation,

Petitioner,

vs.

United States of America,

Respondent.

Petition for Writ of Certiorari
to the United States Court of Appeals
for the Fifth Circuit

Petition for Writ of Certiorari

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QUESTION PRESENTED

Does section 502(b)(2) of the Bankruptcy Code stop the accrual of legal liability for interest on pre-petition claims against a corporation in bankruptcy such that the corporation may not deduct that interest expense on tax returns filed on the corporation's behalf?

LIST OF PARTIES

The following is a list of all parties to the proceeding in the United States Court of Appeals for the Fifth Circuit, whose judgment is sought to be reviewed:

Appellant:
Walter C. Kellogg, Trustee for West Texas Marketing Corporation

Appellee:
United States of America

West Texas Marketing Corporation has the following parent companies or subsidiaries within the meaning of Supreme Court Rule 29.1:

None.

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Respondent.

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for the Fifth Circuit

TO THE UNITED STATES SUPREME COURT:

Walter C. Kellogg, Trustee of West Texas Marketing Corporation, asks this court to issue a writ of certiorari to review the opinion issued May 31, 1995, by the United States Court of Appeals for the Fifth Circuit.

OPINIONS AND JUDGMENTS BELOW

Petitioner has reproduced in a separate appendix the opinions and judgments which the courts below have issued. The opinions and judgments are as follows:

In re West Texas Marketing Corp. (Kellogg v. United States), 54 F.3d 1194 (5th Cir. 1995) (court of appeals decision).

In re West Texas Marketing Corp. (Kellogg v. United States), No. 1:93-CV-124-C (N.D. Tex. Dec. 20, 1993) (district court decision).

In re West Texas Marketing Corp. (Kellogg v. United States), 155 B.R. 399 (Bankr. N.D. Tex. 1993) (bankruptcy court's decision).

JURISDICTION

The court of appeals issued its opinion May 31, 1995. The court of appeals denied Kellogg's petition for rehearing July 26, 1995. This court has jurisdiction, pursuant to 28 U.S.C. § 1254(1) (West 1995), to review the decision of the court of appeals.

STATUTES INVOLVED

11 U.S.C.A. § 502(b)(2) (West 1993 & Supp. 1995):

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount except to the extent that —

. . .

(2) such claim is for unmatured interest; . . .

11 U.S.C.A. § 726(a)(5) (West 1993 & Supp. 1995):

(a) Except as provided in section 510 of this title, property of the estate shall be distributed —

(1) first, . . .

(2) second, . . .

(3) third, . . .

(4) fourth, . . .

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; . . .

STATEMENT OF THE CASE

The court of appeals opinion correctly states the facts.

In 1982 West Texas Marketing filed for bankruptcy. The bankruptcy court eventually converted the chapter 11 case to a chapter 7 liquidation. The bankruptcy court had jurisdiction of this case pursuant to 28 U.S.C. § 157 (West 1995).

West Texas Marketing had maintained its records and calculated its federal income tax liability using the accrual method of accounting (III R. 207). In 1991, Walter Kellogg, as trustee for the bankruptcy estate, filed amended tax returns for West Texas Marketing for 1988 and 1989, asserting that the company (1) had failed previously to deduct post-petition interest on resolved unsecured claims for 1988 and 1989; and (2) could deduct net operating loss carryforwards based, in part, on post-petition interest for such claims for 1982 through 1987. Kellogg also sought to deduct post-petition interest for such unsecured claims on the 1991 tax return for West Texas Marketing. The total interest expense was about $12.6 million, which gave rise to the total refund claim of approximately $1.1 million. The IRS disallowed the refunds.

Kellogg filed an adversary proceeding to recover the refund. The case was tried on stipulated facts. Kellogg argued that under the Fifth Circuit's decision in *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955), it was proper to deduct post-petition interest on pre-petition claims against the debtor because the debtor's obligation to pay that interest was fixed and unconditional, and that satisfied the "all events" test for the deduction of this expense. *See* I.R.C. § 461 (outlining the elements of the "all events" test); Treas Reg. 1.461-1(a)(2)(i) (1992) (same).

The bankruptcy court decided that *Fahs* was no longer the law in the Fifth Circuit. The court also decided that under 11 U.S.C. § 726(a)(5) post-petition interest on claims is not a fixed liability under the "all events test" because interest on claims filed in a chapter 7 bankruptcy case is payable from the bankruptcy estate only after payment in full of all allowed claims, and only if after the payment of those claims there are assets in the estate with which to pay such interest.

On appeal, the district court affirmed the bankruptcy court's ruling without substantive comment.

The Fifth Circuit concluded that Kellogg had failed to show that all events had occurred which would establish the corporation's liability for post-petition interest. The court based its conclusion on the effect of sections 502 and 726 of the Bankruptcy Code. Section 502(b)(b) provides that a claim filed in a bankruptcy case shall be allowed unless "such claim is for unmatured interest." 11 U.S.C.A. § 502(b)(2) (West 1993 & Supp. 1995). The court decided that under section 502(b)(2) "interest stops accruing at the date of the filing of the petition."

The court then noted that under section 726, payment from the estate of post-petition interest on allowed claims is made only after payment of these prior claims. 11 U.S.C.A. § 726(a)(5) (West 1993 & Supp. 1995). The court concluded that "if, in the distribution of WTMC's assets in accordance with § 726(a)(1)-(4), all assets are depleted, then the estate will not have incurred any obligation to pay interest on un-secured claims."

As a result of its interpretation of these two provisions of the Code, the court concluded that "the condition necessary to create the liability for the post-petition interest failed to occur." What had failed to occur, according to the court, was the event that made certain the liability for interest on these creditors' claims — payment from the estate of all claims under section 726(a)(1)-(4), and the availability of sufficient assets in the estate to pay interest on the creditors' claims under section 726(a)(5).

In other words, the court held that the obligation to pay from the estate post-petition interest on creditors' claims was only a contingent liability. Because that liability was contingent rather than fixed, the liability did not satisfy the first element of the "all events" test. Because the interest expense did not satisfy the "all events" test in the court's view, West Texas Marketing could not deduct that interest.

The dissent argued that the majority improperly treats section 502(b) as a substantive rule rather than as a rule of convenience for the rational administration and distribution of the assets of the bankruptcy estate. According to the dissent, the majority has ruled in effect that section 502(b) *voids* the state-law obligation to pay interest, reimposing that obligation under section 726(a)(5) only if sufficient estate assets remain to pay interest after distribution of etate assets to pay claims under section 726(a)(1)-(4). Such a ruling, the dissent noted, was contrary to a substantial body of precedent established by this Court.

REASONS FOR GRANTING THE PETITION

The holding of the Fifth Circuit could impact tens of thousands of bankruptcy cases. The decision will impact any case in which a debtor or its trustee seeks a tax deduction for the expense of accrued post-petition interest. The decision could have two wide-ranging effects. First, it could deprive bankruptcy estates and creditors of a valuable asset in the form of a tax refund made available based on the deduction of post-petition interest. By denying the debtor a deduction to which it is otherwise entitled, and by allowing the IRS to retain taxes that the debtor paid, creditors whose claims might otherwise be paid, at least in part, are not paid. This results in a windfall for the IRS, at the expense not of the debtor, but of the creditors who might otherwise have their claims paid from funds in the bankruptcy estate.

Second, with regard to all corporate debtors and those individual debtors who do not achieve a discharge by reason of their bankruptcy, the decision effectively eliminates the obligation to pay post-petition interest on debts which were not paid in the bankruptcy. Creditors whose claims are not paid in the bankruptcy thus have no basis for recovering post-petition interest against the debtor after the bankruptcy is over, even as to nondischarged debts.

A. The decision deprives bankruptcy creditors of a valuable asset.

One can best understand this matter by contrasting the situation of a corporation in bankruptcy with the situation of a financially troubled corporation not in bankruptcy. If a corporation is unable to pay substantial debt but declines to file a bankruptcy (and if no creditor group files involuntary bankruptcy against it), then based upon the tax regulations

and statutes as they now stand that corporation could deduct the interest running on its debts as it winds up its affairs, even though the corporation may never be financially able to pay any of that interest. If so, the corporation could obtain a tax refund based on such deductions and use these funds to make a distribution to its creditors on some pro rata basis.

By contrast, if the corporation files bankruptcy or is put there involuntarily, the outcome would be different if the court of appeals' decision stands. Although the purpose of a bankruptcy is to administer the debtor's assets for the benefit of creditors and to enhance the recoveries of those creditors, under the court of appeals' decision the corporation that does not have sufficient assets to pay all its claims and decides to file bankruptcy cannot deduct post-petition interest on those claims and thus is not entitled to a tax refund based on that deduction.

As a result, the corporation and its creditors cannot achieve in a bankruptcy what they could otherwise achieve in a nonbankruptcy context. This makes no sense. Bankruptcies are supposed to help the creditors rather than harm them. By misinterpreting the intent and effect of sections 502 and 726 of the Bankruptcy Code, the Fifth Circuit frustrates rather than furthers the purposes of bankruptcy administration.

B. The decision eliminates a corporate debtor's liability for post-petition interest on nondischarged debts.

A corporation involved in a chapter 7 bankruptcy does not receive a discharge. *See* 11 U.S.C.A. § 727(a)(1) (West 1993). A debt that is not discharged survives the bankruptcy, and a creditor may satisfy that debt from the debtor's post-petition assets. *See generally* 8A C.J.S. *Bankruptcy* § 349 (1988). This is confirmed by cases going as far back as *New*

Lamp Chimney Co. v. Ansonia Brass & Copper Co., 91 U.S. 656 (1875). In that case, a plaintiff brought suit for recovery on several promissory notes signed by a corporation that had been declared bankrupt. During the bankruptcy, the plaintiff had filed claims relating to these notes and received partial payment by means of the distributions from the estate. The corporation argued that because the plaintiff had received some payment in the bankruptcy, the present claims based on these same notes should be dismissed. This Court disagreed, noting that since the corporation did not receive a discharge, the plaintiff was entitled to pursue its claims on these notes even after the bankruptcy. *Id.* at 666.

More recently, in *Bruning v. United States*, 376 U.S. 358 (1964), this Court held that the government was entitled to recover, from assets acquired by a debtor after bankruptcy, post-petition interest on a tax assessment which had not been discharged. This Court rejected the argument that the rule which suspends post-petition interest against the estate applies to discharge the debtor from any liability for such interest.

The reason that Congress decided a corporation's debt would not be dischargeable was so that the corporation that continued to operate could not, after the bankruptcy, avoid any previously incurred debt. *See NLRB v. Better Building Supply Corp.*, 837 F.2d 377, 379 (9th Cir. 1988). The court of appeals' decision completely unravels Congress's policy in this respect, at least with regard to a chapter 7 corporate debtor's continuing liability for interest accruing after the filing of the bankruptcy petition. Based on this decision, a creditor cannot recover from such a corporate debtor interest on the corporation's debt after the bankruptcy filing if the estate did not have sufficient assets to pay all claims.

C. The decision is wrong.

The Internal Revenue Code allows the deduction of all interest accrued on indebtedness within the taxable year. I.R.C. § 163(a). The Code requires that taxable income be computed, and deductions taken, using the accounting method which the taxpayer normally uses. I.R.C. §§ 446(a), 461(a).

West Texas Marketing Company had used the accrual method of accounting. Under the accrual method an expense is incurred and must be taken into account for federal income tax purposes in the taxable year in which all the events have occurred which establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(i) (1992); I.R.C. § 461(h)(4). This is the so-called "all events" test.

The issue this case raises is whether the Bankruptcy Code alters the "all events" test in any manner. The court of appeals in effect decided that it did. The correct answer is that it does not.

When a bankruptcy petition is filed, the filing creates an estate comprised of certain categories of property of the debtor, regardless of where it is located and by whom it is held. 11 U.S.C.A. § 541(a) (West 1993). The property of this estate is administered and distributed to creditors in the bankruptcy case; the Bankruptcy Code imposes on all parties a distribution scheme designed to achieve both administrative convenience and equity of sharing. *See* 11 U.S.C.A. § 726(a) (West 1993). In order to foster these purposes, Congress prohibited payments from the estate for post-petition interest on claims unless and until the claims themselves are first paid. *See In re West Texas Marketing Corp. (Kellogg v.*

United States), 54 F.3d 1194, 1204 & n.8 (5th Cir. 1995) (Smith, J., dissenting) (citing extensive legislative history behind section 502(b)(2)).

This distribution scheme, however, has relevance only to the fair disposition of the property of the estate. The bankruptcy estate and the debtor are two distinct entities. The debtor has a life separate from the estate. The debtor is subject to all legal obligations it has created, and in the case of a chapter 7 corporate bankruptcy, the obligations are not eliminated by the filing of the bankruptcy. Similarly, the corporate debtor rather than the estate is the entity whose income is subject to the tax. *See* I.R.C. § 1399. Thus, the distribution scheme of sections 502 and 726 is not intended to limit the liability of the debtor, particularly as regards corporate debtors who remain liable for their debts notwithstanding a chapter 7 bankruptcy. 11 U.S.C.A. § 727(a)(1) (West Supp. 1993).

This Court has reaffirmed on several occasions that the rules regulating distribution to creditors of the assets of the bankruptcy estate do not create substantive rights but are in fact rules of convenience to aid the court in administering the rational, orderly payment of the debtor's obligations. In the case of *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946), this Court explained that "[t]he business of bankruptcy administration is to determine how existing debts should be satisfied out of the bankrupt's estate so as to deal fairly with the various creditors. The existence of a debt between the parties to an alleged creditor-debtor relation is independent of bankruptcy and precedes it. . . . [T]he law that fixes legal consequences to transactions is the law of the several States." 329 U.S. at 169 (Frankfurter, J., concurring). Similarly, in *Nicholas v. United States*, 384 U.S. 678 (1966), this Court concluded that the accumulation of interest on

claims against a bankrupt estate is suspended as of the date the petition in bankruptcy is filed. However, "the interest-bearing quality of the debt is suspended, rather than extinguished" by the filing of the petition, and under some circumstances the accrual of the interest can continue during administration of the bankruptcy. *Id.* at 682 & n.9.

Recent cases confirm that the same result occurs under the Bankruptcy Code of 1978. *See In re Fullmer (Fullmer v. United States)*, 92-1 U.S. Tax. Cas. (CCH) ¶ 50,237 (10th Cir. Apr. 28, 1992); *In re Hanna (Hanna v. United States)*, 872 F.2d 829, 831 (8th Cir. 1989); *In re Burns (Burns v. United States)*, 887 F.2d 1541 (11th Cir. 1989). This Court has not abandoned *Vanston*. *See Bruning v. United States*, 376 U.S. at 362 n.4; *see also Grogan v. Garner*, 498 U.S. 279, 283 (1991) ("The validity of a creditor's claim is determined by rules of state law.").

In short, section 502(b)(2) of the Bankruptcy Code is a non-substantive rule; it does not void the state law right to interest but merely regulates the distributions from the estate to pay for that interest, in conjunction with the priority distribution scheme in section 726. *See In re Wilson*, 56 B.R. 693, 695 (Bankr. M.D. Ala. 1986) ("Disallowance of claims for post-petition interest is a rule of policy and convenience and not a statement of substantive law.");. 3 COLLIER ON BANKRUPTCY ¶ 502.20[2], at 34-35 (15th ed. 1995) (same).

The Fifth Circuit's prior decision in *Fahs v. Martin*, 224 F.2d 238 (5th Cir. 1955), is an appropriate application of *Vanston* in this context. In *Fahs*, a bankruptcy trustee tried to deduct interest, owed on mortgage indentures, that accrued during the bankruptcy. The government argued that the post-petition interest was not accruable and deductible for income tax purposes in view of the fact that there was little or no

likelihood that it would ever be paid. 224 F.2d at 393. The court decided, however, that the contingency as to payment of the interest did not prevent accrual of that interest. The court said that "interest on an unconditional legal obligation is deductible for income tax purposes by an accrual basis taxpayer, notwithstanding the improbability of its being paid . . . ." *Id.* at 395.

With regard to *Vanston*'s reasoning the court said that "[t]he *Vanston* case seems to us to establish a rule only for the distribution of a bankrupt's assets. It did not hold that such a claim was void, but only that the claimant should not participate in the distribution of assets until all claims superior in conscience and fairness were paid." 224 F.2d at 394. The court followed that reasoning in interpreting the Bankruptcy Code of 1978. *See United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.*, 793 F.2d 1380, 1386 n.5 (5th Cir. 1986) ("the petition suspended the contract right to accrue interest; it did not extinguish the right."), *reinstated*, 808 F.2d 363 (5th Cir.) (en banc), *aff'd*, 481 U.S. 1068 (1987); *see also In re Brints Cotton Mktg., Inc. (Addison v. Langston)*, 737 F.2d 1338, 1341-42 (5th Cir. 1984).

With the present decision, the court of appeals has sidestepped administrative rulings and regulations which confirm that the deduction of interest in this context is appropriate. *See, e.g.*, Rev. Rul. 70-367, 1970-2 C.B. 37; I.T. 3635, 1944 C.B. 101.

The Bankruptcy Code is designed to allow an efficient administration and equitable distribution of the bankruptcy estate. If a claim against the estate could include unmatured interest, then the claim would be changing daily, creating a nightmare of administration, because pro rata distribution to

be made on each claim would change on a day-to-day basis and on a claim-by-claim basis. Trustees either could never make a precise distribution, or they would spend inordinate money making calculations of the distributions on each distribution date. The purpose of the bankruptcy rules is to avoid this problem. The court of appeals has ignored this fundamental purpose, thereby creating the potential for problems arising from future bankruptcy administrations.

CONCLUSION

For these reasons, this court should grant this petition for writ of certiorari.

Respectfully submitted,

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